CENTRAL BANKING

The central banker as god

1998 may be remembered as the year in which the power of central bankers reached its zenith. They should enjoy their moment of glory: it will not last

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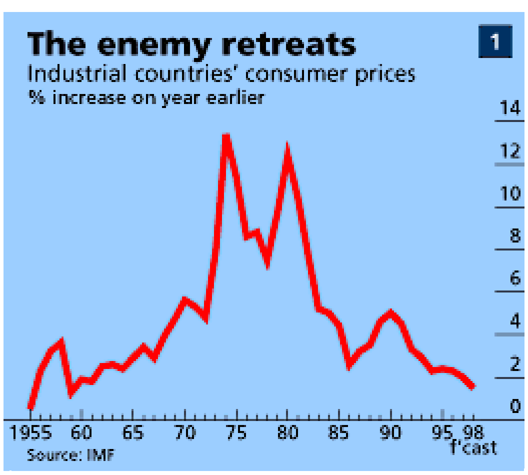
THE past decade has witnessed one of the biggest bull markets of all time. Not least, it seems, for central banks. In country after country monetary policy has been taken away from unreliable politicians and handed to upstanding central bankers. The new European Central Bank (ECB) epitomises the bankers' ascendancy. From next January the ECB will be the most powerful central bank in the world, even more insulated from outside political pressures than is Germany's Bundesbank today.

In America, too, the influence of the Federal Reserve has grown—and its public image has hugely improved. In 1982 a Tennessee construction journal carried on its cover a "wanted" poster of Paul Volcker and the other six Fed governors—"The Maleficent Seven"—accusing them of "premeditated and cold-blooded murder of millions of small businesses". Today, Alan Greenspan, Mr Volcker's successor as chairman of the Fed, is revered as a god by most investors and voters.

Central bankers were given their new status and power only after years of high inflation had led to the conclusion that politicians could no longer be trusted with monetary policy. And judged by consumer prices, the bankers can certainly claim to have delivered: the average inflation rate in the rich industrial economies has fallen to 1.5% this year, its lowest rate since the 1950s (see chart 1).



Ironically, it is their very success in delivering “price stability” that may now lead to the decline of central bankers’ influence, in two ways. First, with the apparent death of inflation—the enemy they were given such freedom to fight—their legitimacy is being challenged. And second, while central banks have been able to declare the battle for “price stability” won, there are growing doubts about whether they have been neglecting other sorts of inflation, especially in asset prices.

Even before the ECB takes the monetary reins, its power and autonomy have come under political attack. The Maastricht treaty, which gives the ECB independence to pursue its goal of price stability, was negotiated by politicians from largely centre-right governments. Now the left controls or shares power in nine of the 11 countries that will adopt the euro. And several of the newcomers are less persuaded than their predecessors of the virtues of monetary (and indeed fiscal) discipline.

By far the most significant is Germany’s new Social Democrat-led government of Gerhard Schröder. It was Mr Schröder’s predecessor, Helmut Kohl, who so eagerly preached the doctrine of central-bank independence at Maastricht. Yet the new German finance minister, Oskar Lafontaine, has wasted no time telling the Bundesbank and the ECB that they should pay as much attention to job creation as to inflation.

In other European countries, too, the notion that central banks should shift their sights from inflation to output and jobs has gained support. This could put the ECB on a collision course with politicians. Indeed, there is a risk that this political bullying might make the ECB more wary than it would otherwise be about cutting interest rates next year, purely so as to flaunt its independence. As one central banker puts it, “we are like whipped cream—the more you beat us the harder we become.”

In America, in contrast, most politicians and voters think that the Fed has done a fine job. It has delivered over seven years of uninterrupted growth and low inflation. Mr Greenspan’s halo slipped only slightly in September, when he was criticised for not making bigger interest-rate cuts at a time when the world seemed to be on the brink of financial meltdown. But his unexpected rate-cut in October has been widely praised—and it has helped push Wall Street up by almost one-fifth from its September low.

Yet Mr Greenspan is still walking a particularly delicate tightrope. Share prices could easily tumble once more, and America’s economy may sink into recession next year—even if interest rates are cut again. In such an event, he may quickly be turned by America’s fickle public from god to devil.

Indeed, as economies in both America and Europe slow next year, the challenges to today’s accepted wisdom—that central banks should be independent, and should be given a prime or even only goal of price stability—will surely grow. Yet the case for putting monetary policy in the hands of an independent central bank remains strong. Politicians may be tempted to engineer a boom ahead of an election, knowing that inflation will take off only after the votes have been counted. That means that governments’ anti-inflationary policies lack credibility, encouraging workers to demand bigger pay rises and investors to seek higher bond yields. If, instead, independent central banks are put in control of interest rates, inflation can be defeated at a smaller cost in lost output and jobs.

Even such critics as Mr Lafontaine insist that they are not questioning the independence of central banks, just their methods. They may even have a point. Central bankers, unlike the pope, are fallible—and they have made plenty of mistakes in recent years. However, their blunders have not been those of which they usually stand accused. Any appraisal needs to distinguish carefully between the charges that are being laid against them.

Off target

The first is that central banks should focus on growth as well as inflation. The second is that central banks are too secretive. The third, and perhaps most serious, is that central banks may be focusing on too narrow a measure of inflation.

The notion that central banks should care as much about output and jobs as they do about inflation reflects a misunderstanding. It starts from the fallacy that a low inflation target will permanently choke growth. Yet the bulk of continental Europe's 11% unemployment rate, which is Mr Lafontaine's gripe, is not due to insufficient demand caused by high interest rates. Rather, it results from structural rigidities in Europe's labour and product markets. A looser monetary policy would have no long-term effect on output and jobs; it would simply push up inflation. That reinforces the case for price stability being the right long-term goal for the ECB—and for all central banks.

Moreover, aiming at an inflation target does not mean ignoring growth and employment. Central banks take account of both in forecasting the future path of inflation. The ECB's critics make much of the fact that, by law, America's Fed is supposed to worry about jobs as well as inflation, and they point to its recent interest-rate cuts as proof of its greater tolerance of inflation. But in recent years, the Fed has, in practice, given priority to inflation.

The second topical complaint about central banks—that they lack accountability and transparency—applies especially strongly to the ECB. The danger is that without some accountability to elected politicians, the ECB will find it hard to secure the sort of public support that is enjoyed by the Bundesbank and the Fed. It could become an easy scapegoat for politicians when things go wrong.

In a democratic society, the best way to win legitimacy and public trust is openness. But the ECB has decided that, unlike the Fed or the Bank of England, it will publish neither the minutes of its policy meetings nor details of how members vote. This reticence may make it an easier target for those attacking its independence.

The third criticism of central banks is more controversial. Although most economists agree that inflation, not jobs, is the right target for a central bank, they differ on a crucial point: what measure of inflation? The recent economic crises in Japan and East Asia show that unsustainable booms can happen even when consumer-price inflation is low. In each case, lax monetary conditions drove up the prices of equities and property, but not of goods and services. Yet bubbles always burst in the end, with painful consequences.

This is worrying, not least because there are reasons to fear that a bubble has been swelling in the United States, too. On the surface, its economy looks healthy, with inflation currently running at only 1.5%. But the consumer-price index by which inflation is measured does not include rising prices for financial assets. Some stockmarket analysts claim that high share prices reflect the productivity gains of the “new economy”. But look closer and there are symptoms of financial excess. To mention only three, share prices remain overvalued by most historical measures; the broad money supply has been growing at its fastest rate for 13 years; and the household savings rate has turned negative for the first time since the 1930s.

Thus, far from being dead, inflation may have merely assumed a different guise. And the lesson, as *The Economist* argued earlier this year, is that central banks should pay attention to the prices of assets as well as monitoring the prices of goods and services.

Central banks already take account of rising share prices if they threaten to spill over into general inflation as consumers are encouraged to spend some of their capital gains. But even if a stockmarket boom has no impact on inflation (which measures the rising price of current consumption), central banks should still worry about inflation in asset prices (which reflect claims on future consumption). Just as with normal consumer-price inflation, asset-price inflation can misallocate resources in the economy by distorting price signals. Rapid increases in the prices of equities and property may encourage firms to over-invest, or investors to over-borrow, as they bet on future capital gains.

Asset-price inflation carries another danger: that prices will overshoot and then collapse. This has been seen repeatedly: recent examples include Japan and Hong Kong. The collapse can then trigger broader economic and financial instability, to which central banks feel obliged to respond. It would clearly be wiser to prevent a bubble forming in the first place. As history has shown, the longer a bubble lasts, the bigger the bang when it bursts.

So there is a strong theoretical argument for central banks to pay more attention to asset prices. That does not mean aiming for a particular level in, say, the American stockmarket; but it might mean that a sharp rise in share prices is treated as one more signal pointing towards higher interest rates. Central bankers, however, seem reluctant to heed such signals.

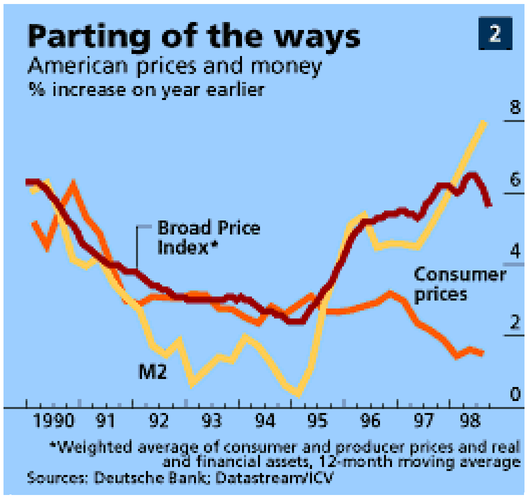
One reason is that it is hard to tell a bubble when you see one. Rising share prices might be justified by strong economic fundamentals and higher future profits. It is surely dangerous to assume that central banks know better than the market. But even if asset-price inflation is hard to measure, this is a poor excuse for ignoring rising share prices—especially when they are accompanied, as recently in America, by rapid monetary growth and other signs of froth in the economy.

Hubble bubble, asset-price trouble

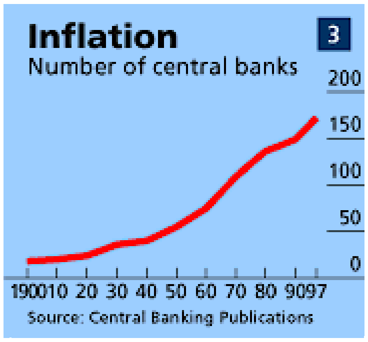
Even if it is clear that a bubble is being inflated—as some in the Federal Reserve believed earlier this year—what should be done about it? The link between monetary policy and asset prices is unclear. A sharp rise in interest rates might trigger a stockmarket crash, which would bring down on central bankers the wrath of politicians and shareholders, and maybe do serious economic harm. Most people view a rise in consumer prices as a bad thing, but a rise in equity or house prices is usually welcomed—not least by the 50% of American households that own shares.

Indeed, there is a curious asymmetry in attitudes towards movements in share prices. It is generally accepted that if share prices tumble, central banks should stand ready to cut interest rates to protect economies from the fall-out. But it is surely inconsistent then to argue—as many do—that the Fed should not usually interfere when they are surging onwards and upwards.

This debate goes back to 1911, when Irving Fisher, an economist, argued that policymakers should aim to stabilise a broad price index that included shares, bonds and property as well as goods and services*. Now Joseph Carson, an economist at Deutsche Bank in New York, has constructed such a price index for America. Although shares have a weight of only 5% in the index, it surged during 1996 and 1997 at its fastest rate since the late 1980s (see chart 2)—a sign that monetary policy needed to be tightened. If America's bubble bursts and its economy goes into recession, the Fed will inevitably be blamed for not cutting rates sooner. Its real mistake, however, may have been not to raise rates some years ago.



When consumer-price inflation is subdued, there is an obvious objection to raising interest rates to prick an asset-price bubble: that it could result in deflation elsewhere. But, argues James Grant, editor of *Grant's Interest Rate Observer*, a financial newsletter, that is exactly what should have been happening in recent years. In a period of rapid technological change and large productivity gains, he argues, prices should be falling, just as they did in the late 19th century. This is the benign type of deflation, not the virulently malignant kind seen in the 1930s.



Mr Grant accuses the Fed of having inadvertently pursued an over-expansionary monetary policy that helped to fuel the bull market. Its mistake, he argues, was to aim for price stability, rather than to allow prices to fall in line with productivity gains. This is similar to the 1920s—also a decade of rapid technological progress—when the Fed propped up product prices with easy credit, which then inflated share prices. Interestingly, in its *Federal Reserve Bulletin* in 1937, the Fed admitted that a falling price level in the 1920s might have helped to maintain overall financial stability.

Some economists conclude from such episodes that central banks have tended to do more harm than good: their actions can create instability rather than stability. On the surface it seems an anomaly that, while most other prices in the economy are being deregulated and exposed to market forces, central banks continue to fix the price of money—ie, interest rates. Why should the Fed know what the correct interest rate is, any more than a government knows the correct level of rents? Central bankers, says Mr Grant and his supporters, have become the central planners of the late 1990s.

Suppose interest rates were, instead, determined in the money markets, by the supply of savings and the demand for them. Then, in recent years, as borrowing exploded, they would automatically have risen, helping to cool the boom. Mr Grant argues that the Fed's intervention has upset this balance. In particular, the Fed suppressed rates in the early 1990s in order to bail out the banking system. In the process it unleashed a credit boom and widespread underpricing of risk.

Who needs them?

Might we be better off without central banks at all? Countries used to manage without them, after all. In 1900, only 18 countries had a central bank, compared with 172 today (see chart 3). And many economists have argued that a further fault of central banks is that, by acting as lender of last resort to the banking system, they foster moral hazard: banks lend more recklessly because they know they will be bailed out if things go wrong.

For these reasons, some economists have advocated free banking, in which private banks issue their own bank-notes that circulate freely in competition with other banks. Walter Bagehot, a 19th-century editor of *The Economist*, at one time also favoured doing without a central bank, but accepted that "proposing to do away with the Bank of England is as futile as proposing to end the British monarchy." Yet now that the monarchy is no longer revered, should the Bank stay sacrosanct?

In today's financial system, it would be fanciful and dangerous to scrap the lender of last resort altogether. Likewise, although it may sound attractive in theory to allow the market, rather than central banks, to set the level of interest rates, it could be dangerous in practice. Financial markets are by nature volatile, subject to under-and overshooting. In the 19th century, before the Fed existed, America still suffered severe boom-and-bust cycles That central banks have failed to end booms and busts is not, in the end, a sufficient reason to take monetary policy away from them—still less to give it back to politicians. Rather, it is an argument for seeking better ways to conduct monetary policy.

The notion that if governments simply gave central banks their independence all economic ills would be cured was always naive. Politicians, markets and voters expect too much of central banks. Such is the current faith in Mr Greenspan that he is expected to deliver full employment, price stability, a strong banking system and a rising stockmarket. Nobody, even Mr Greenspan, can achieve all this. Yet markets' belief that he can fuels the view that the boom can continue for ever.

Central banks' monetary levers have always worked clumsily, and the evolving shape of the financial system has made their job harder still. The task of central bankers has traditionally been defined by three words: money, banks and inflation. Over the past two decades of financial innovation, central bankers have struggled with the questions of “what is money?” and “what is a bank?”. Now, at the pinnacle of their power, it is disconcerting that they need to ask “what is inflation?”.

“How do we know when irrational exuberance has unduly escalated asset values? . . . And how do we factor that assessment into monetary policy?” Mr Greenspan asked the right question in December 1996. But his failure then to act to prick the bubble may yet prove to have been a big mistake. But Mr Greenspan is not a god, after all.

* Two related articles are: “On a Correct Measure of Inflation” by Armen Alchian and Benjamin Klein, *Journal of Money, Credit and Banking*, 1973; and “Less Than Zero: the Case for a Falling Price Level in a Growing Economy” by George Selgin, IEA Hobart paper no.132, 1997.